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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS:

MARC SPITZER, Chairman
WILLIAM A. MUNDELL
JEFF MATCH-MILLER
MIKE GLEASON
KRISTIN K. MAYES

In the matter of:

YUCATAN RESORTS, INC., d/b/a YUCATAN RESORTS, S.A.,

RESORT HOLDINGS INTERNATIONAL, INC. d/b/a RESORT HOLDINGS INTERNATIONAL, S.A.,

WORLD PHANTASY TOURS, INC. a/k/a MAJESTY TRAVEL a/k/a VIAJES MAJESTY

MICHAEL E. KELLY,

Respondents.

DOCKET NO. S-03539A-03-0000

RESPONDENTS' JOINT REPLY IN SUPPORT OF JOINT MOTION FOR SANCTIONS

(ASSIGNED TO THE HONORABLE MARC STERN, ADMINISTRATIVE LAW JUDGE)

Arizona Corporation Commission
DOCKETED

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I. INTRODUCTION.

At the March 4, 2004, Pre-Hearing Conference, the Securities Division (hereinafter "Division") stated:

> Touching on the comment that this belongs in the Department of Real Estate, there had been at least eight and probably more securities divisions across the country *that have issued rulings against the respondents in this case. Clearly, they [other securities divisions] have found it [the Universal Lease] to be a security. See* March 4th Pre-Hearing Conference Transcript at p. 24, lines 8-12.

The Division admitted that it made this statement in its Response to the Joint Motion to Compel (hereinafter "Response"). *See* Response at p. 4, lines 19-23. Despite this admission, there is no effort by the Division to sincerely correct the record, as counsel has an obligation to do under applicable ethical rules. *See* AZ-ER 3.3(a)(3); ABA Model Rules 3.3(a)(3).

Instead, the Division's Response is comprised of backpedaling, spinning and *ad homonym* attacks on the Respondents' counsel for pointing out that the Division made damaging and false statements to the Tribunal. Rather than just acknowledge that the statements were reckless and inaccurate, the Division actually cites, as justification for the statements, a *decade-old* definition from *Merriam-Webster's II New Riverside University Dictionary* (1994), which the Division unquestionably dug up *after* making the prejudicial statements. Response at p. 4, line 1.

The fact is the Division grossly mischaracterized what "eight and probably more" state securities divisions had done with regard to one or more of the Respondents in this action.[1] Moreover, after making assertions of a "ponzi scheme on a national level" at the last Pre-Hearing Conference, the Division does not even make reference to its assertions of a ponzi scheme in its Response.[2] The Division's comments have tainted this proceeding, and irrefutably prejudiced the Respondents. Therefore, sanctions are appropriate and should be applied in this instance.

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[1] *See* March 4th Pre-Hearing Conference Transcript at p. 24, lines 8-12.
[2] *Id.* at p. 5, lines 4-9.

II.
ARGUMENT

Nowhere is the precise and accurate use of language more critical than in the practice of law. In its Response, the Division seeks to avoid the consequences of its statements by reinterpreting the plain language of its representations at the March 4th Pre-Hearing Conference. The Division stated:

> Touching on the comment that this belongs in the Department of Real Estate, there had been at least eight and probably more securities divisions across the country *that have issued rulings against the respondents in this case. Clearly, they [other securities divisions] have found it [the Universal Lease] to be a security. See* March 4th Pre-Hearing Conference Transcript at p. 24, lines 8-12.

There is no ambiguity in this statement. The Division represented that at least eight securities divisions had issued rulings that found the Universal Lease to be a security and the Respondents to be in violation of state securities laws. *Id.* This representation is not accurate: the Division had the seven, *not eight*, "rulings" in its possession prior to making the assertions and, thus, the Division knew that not one of the "rulings" had found that the Universal Lease was a security.

A. The Representations Were Not Just Semantics – They Were False.

The Division attempts to lessen or negate the prejudicial impact of its misstatements by: (1) asserting the interpretation of its statements is just a matter of "semantics," or a "subjective, hyper-technical reading" by the Respondents[3]; and (2) justifying its statements because they were made in response to the Respondents' argument that this case belongs in the Real Estate Division.[4] However, words have profound meaning in the practice of law, and the Division cannot escape the plain language of its statements.

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[3] Response at p. 3, lines 18-20.
[4] Response at p. 4, lines 1-2.

The Division noted that the Respondents took exception to the Division's use of the term "ruling" where the Division indicated that at least eight securities divisions had issued rulings against the Respondents. *Id.* at p. 3, lines 22-25. Thereafter, the Division admitted that what existed was not eight or more "rulings" but, rather, "prior securities division 'orders.'" *Id.*

A "ruling" is "the outcome of a court's decision either on some point of law or on the case as a whole".[5] Thus, when the Division stated that at least eight securities divisions had issued rulings against the Respondents, and that those divisions found the Universal Lease/Respondents' programs to be a security, it is irrefutable that the Division indeed was expressing that these divisions found the Universal Lease to be a security and the Respondents guilty of violating the respective state securities laws. This statement is not accurate, and it was intended to, and did, prejudice the Respondents in this action.

It is absolutely astounding that the Division attempts to avoid responsibility for its statements by asserting that, "viewed within the proper context, the Division's comment was at once germane and appropriate; the Division responded to respondents' challenge that this matter did not belong in the current securities forum, and the Division cited outside precedent to support its position." Response at p. 5, lines 6-10. The "context" does not make the ensuing statement magically true. No matter in what context you place the Division's statement, the plain meaning of the statement is clear, inaccurate, and sanctionable.

B. The "Rulings" Establish the Falsity of the Division's Statements.

In not one instance did the Division's representations match up with the "rulings" that the ALJ forced the Division to produce after its reckless comments. Remarkably, the Division repeated its misstatements in the Response. In order to dodge responsibility for its above-

[5] BLACK'S LAW DICTIONARY 1334 (7th ed. 1999).

referenced comments and to support additional misstatements in its Response, the Division dug up a 1994 definition from *Webster's II New Riverside University Dictionary* of "finding." *Id.* at p. 5, lines 19-20. The Division recounted that the Respondents stated that no administrative order ever made findings that the Universal Lease was a security. *Id.* at lines 18-19. Thereafter, the Division claims that this statement by the Respondents was untrue because the State of Minnesota made a finding that the sale of vacation property management programs, i.e., Universal Leases, by Resort Holdings International, Inc. and Resort Holdings International, S.A. de C.V. constituted the sale of unregistered securities and, further, that Respondents consented to this finding. *Id.* at lines 20-23

Once again, the Division is making inaccurate statements that prejudice the Respondents and, which, are subject to being sanctioned. As indicated in the Joint Motion for Sanctions (hereinafter "Joint Motion"), a Consent Cease and Desist Order was filed in February 2003 in Minnesota. *See* Joint Motion at p. 4, ¶ 3. No formal action was commenced, no hearing on the merits of the action was heard, no formal findings of fact were issued and no rulings were issued against the Respondents. *Id.* at p. 5. It was an informal investigation, and it led to an informal disposition of the matter, ***without any admission or denial of the allegations***. *Id.* ***There was no ruling on the Universal Lease Program, let alone a ruling that the Universal Lease was a security***. *Id.* Thus, the Division's assertion at the last Pre-Hearing conference was inaccurate, and this inaccuracy was compounded by the Division's misrepresentation of the result of the Minnesota inquiry in its Response.

Similarly, the Division misrepresented that the State of Kansas issued a finding that the sale of the Universal Lease constituted the sale of an investment contract, and therefore a security. Response at p. 5, lines 24-26. This too is not true. First of all, ***none of the Respondents in this action were Respondents in Kansas.*** Joint Motion at p. 3, ¶ 1. Secondly, there was: (1) a

Stipulation for Consent Order; and (2) a Consent Order filed by the Kansas Securities Commissioner which prohibited only the sales agent, Carl R. Todd, from making sales. *Id.* There is no mention of RHI or Yucatan, and contrary to the Division's assertions, there were no adverse findings of fact or law issued against any Respondent to the present action. *Id.* Nor was there a finding that the Universal Lease Program was a security. *Id.*

Finally, the Division inaccurately asserted that Wisconsin concluded that the Universal Lease being sold by Yucatan Resorts, S.A. de C.V. was in fact an investment contract security. Response at p. 5, line 26. This is not true, and is a third example of sanctionable representations made in the Division's Response, let alone the blatantly reckless and inaccurate representations made at the last Pre-Hearing conference.

In the Wisconsin action, there was a Petition for Order, and Order of Prohibition (Consent), filed in April 2003. Joint Motion at p. 3, ¶ 2. The named party was Yucatan Resorts S.A. de C.V. *Id.* Importantly, this is not even a named Respondent in the present action. *Id.* The matter was resolved by consent, without any admission or denial of the allegations. *Id.* Contrary to the Division's statement at the Pre-Hearing Conference[6], and in its Response[7], there was no ruling against any Respondent in the present action, or a determination that the Universal Lease Program was a security. *Id.* Thus, the statements by the Division were inaccurate and sanctionable.

C. Sanctions are Supported by the Law and the Facts of this Case.

As indicated in the Joint Motion for Sanctions, which arguments are incorporated herein by reference, there are a number of fundamental ethical requirements that attorneys must follow while practicing law. When an attorney makes an assertion of fact to a tribunal, the attorney is expected to know that the assertion is true or believe it to be true based on a reasonable and

[6] *See* March 4th Pre-Hearing Conference Transcript at p. 24, lines 8-12.
[7] *See* Response at pages 5-6.

diligent inquiry. *See* AZ-ER 3.3 Comments [3]; ABA Model Rule 3.3.[8] Thus, a lawyer who knowingly makes a false statement of material fact violates his or her duty of candor toward the tribunal. AZ-ER 3.3(a)(3), ABA Model Rule 3.3(a)(1)). Moreover, if a lawyer knows (or later learns) that the material evidence the lawyer has presented is false, the lawyer has an affirmative obligation to take reasonable remedial measures. *Id.*

The Division's statements were irrefutably inaccurate and prejudicial. When these statements were made, the Division was in possession of the very "rulings" it asserted were conclusive proof that the Universal Lease was found to be a security and that one or more of the Respondents had violated securities laws around the country. With these rulings in hand, the Division knew of the inaccuracy of these statements.

The Division has had numerous opportunities to correct the record as it is obligated to do. In fact, immediately after inflammatory statements were made at the March 4th Pre-Hearing Conference, the Respondents demanded proof that at least eight securities division have issued rulings against the Respondents, and found the Universal Lease to be a security. Mr. Galbut immediately demanded:

> He says there are eight regulatory agencies that have already ruled on this. I'd like for him to turn over those orders to you today so you can see if there's eight agencies that have done that. And we would like to see them ourselves, because I think we're going to be a bit surprised on that subject. *See* March 4, 2004, Pre-Hearing Conference Transcript at p. 30, line 25 through p. 31, line 5.

The Division did not retract the statement at that crucial point in time. Nor did it take the opportunity to correct its statements in the Division's Response to the Joint Motion for Sanctions. Rather, the Division compounded its sanctionable behavior by reasserting some of the very same inaccurate assertions that it originally made at the Pre-Hearing Conference. *See* Response at pages

[8] *See also* Joint Motion at Exhibits 8 and 9.

5-6; *see also* March 4th Pre-Hearing Conference Transcript at p. 24, lines 8-12. This conduct is reckless, highly prejudicial to the Respondents, and in violation of Arizona Ethical Rules and ABA Model Rules.

Moreover, in its Response the Division stated: "Because there is no merit to their [Respondents] accusations, it is unnecessary to address the flawed reasoning in Respondents' lengthy analysis on sanction." Response at p. 3, lines 6-7. Thus, the legal analysis supporting the Respondents' Joint Motion for Sanctions is uncontested from a legal standpoint by the Division, and must be taken by the Administrative Law Judge as established and a correct statement of the applicable law. Thus, the Respondents' Joint Motion for Sanctions is supported by the facts, is uncontested, as a matter of law, and sanctions should be levied on the Division.

D. Discovery and Disclosure.

The Division also is blatantly stonewalling the Respondents' discovery requests. In its Response, the Division states: "Until a procedural order is issued in this case that sets forth the permissible bounds of discovery in this administrative forum, the Division will continue to reject Respondents' misguided discovery attempts." Response at p. 8, lines 3-5. The Respondents' Motion to Compel or Alternatively to Vacate, which is incorporated herein by reference, fully sets forth both how and why the Respondents are entitled to discovery and, further, how Respondents are being deprived of due process.

The Division's rejection of Respondents' discovery requests also is proof of additional ethical violations by the Division. A lawyer must not unlawfully obstruct a party's access to evidence. AZ-ER 3.4(a); ABA Model Rule 3.4(a). Under a lawyer's duty of fairness to opposing party and counsel, a lawyer must make reasonable efforts to comply with the legally proper discovery requests made by an adversary. AZ-ER 3.4(d); ABA Model Rule 3.4(d).

Moreover, AZ-ER 3.4(d) provides that, during pretrial proceedings, a lawyer may not "fail to make a reasonably diligent effort to comply with a legally proper discovery request by an opposing party." An attorney's non-compliance with another party's discovery request is a violation of AZ-ER 3.4(d) and warrants censure. *See In rea Ames*, 171 Ariz. 125, 829 P. 2d 315 (1992).

The Division has admitted it will not comply with Respondents' reasonable discovery requests. Response at p. 8, lines 3-5. It ignores that fact that just months ago the Division itself was requesting discovery and threatening the Respondents with a battle in Superior Court if the Respondents would not comply with the requests, pursuant to the Arizona Rules of Civil Procedure. Indeed, lead counsel for the Division in this case, stated at the January 14, 2004 Pre-hearing Conference:

> Since the case is going to be extended for some time, ***we would like to do some type of formal discovery requests***. I know they've [the Respondents] been saying we've [the Division] been indicating we're going to do this for some time, but we will try to get this out before March, and ***hopefully they'll comply***. *See* January 14, 2004, Pre-Hearing Conference transcript, at p. 28, lines 1-6 (emphasis supplied).

The Division's counsel further stated:

> . . . Well, our proposal is that ***the respondents produce all sale records*** involving Arizona investors of the universal lease through the year 2003 . . . ***If the respondents refuse to produce the records of 2003 showing the sales to Arizona, then we will be forced to go to the next level and, obviously, take the legal remedies of the Superior Court*** that we need to take. *Id.* at p. 29, lines 7-10, and 16-20 (emphasis supplied).

It is obvious that when the Division did not have the discovery it wanted to present its case, the Arizona Rules of Civil Procedure for discovery applied, and the very same administrative discovery rules that the Division is now attempting, unmeritoriously, to avoid discovery with went out the door. However, when the Respondents want basic discovery to uncover exculpatory

evidence (which the Respondents would never see if the parties were instructed merely to exchange witness and exhibit lists), and they cite to Administrative Rules, applicable Rules of Civil Procedure and supportive case law, the Division snubs the requests, argues that Respondents are not entitled to any discovery, and demands an order from the Administrative Law Judge.

This stance by the Division is in gross disregard of the Respondents' due process rights, and unquestionably sanctionable. The Division will do nothing unless ordered to do so. The ALJ in this matter has indicated that: "we're going to see that you [the Respondents] get due process, no matter what," and that the Respondents are "entitled to due process."[9] Due process requires that the Division comply with the applicable ethical and model rules, which to date they have not done, and that the Respondents be provided with the discovery they have requested. Only then can a fair proceeding on the merits of this action be held.

III.
CONCLUSION

The Division has violated basic ethical obligations to this Tribunal, and to the opposing parties and their counsel. It has created very substantial prejudice to the Respondents, and has tainted these proceedings. Accordingly, Respondents request that the Division be sanctioned by issuing an order with respect to the use of any proceedings in other jurisdictions, which order should:

(a) preclude the offering of any exhibit or other evidence of such alleged proceedings and any future proceedings or orders from any other jurisdictions;

(b) preclude any argument concerning or referencing the orders or so-called "rulings", the subject matter of the "rulings", or the parties named in the "rulings", and any future orders from any jurisdiction;

(c) admonish and prohibit the Division's lawyer from making any statements to

[9] *See* March 4th Pre-Hearing Conference Transcript at p. 27, lines 8-11.

ALJ Stern that are not true, or do not meet the requirement of candor to the tribunal, opposing parties and their counsel, pursuant to the Arizona Rules of Professional Responsibility or the requirement of Ariz.R.Civ. P. 11, so that before making any claim, he conduct a reasonable inquiry that the claim is well grounded in fact and law, and that it is not interposed for any improper purpose, such as, *inter alia*, to create further prejudice, bias, harassment or cause the needless increase in the cost of attorneys' fees in these proceedings; and

(d) require the Division to pay the reasonable expenses of this motion, including attorney's fees and costs, caused by the Division's disregard of his ethical obligations, which has compelled this motion for sanctions.

Dated this 12th day of April, 2004.

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COPY of the foregoing hand-delivered this 12th day of April, 2004 to:

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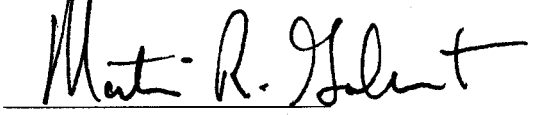

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